Internal Revenue Service

memorandum

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Brl:JCAlbro

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to: Utility Industry Counsel CC:CLE

from: Director, Tax Litigation Division CC:TL

subject: [redacted]-Tax Benefit Doctrine and Sale of a Nuclear Plant

This is in response to your request for technical advice dated June 16, 1988.

ISSUE

Where utilities sell a percentage ownership in a nuclear plant with the sales price computed on the basis of actual costs incurred, is the previously deducted interest portion a reimbursement and, therefore, ordinary income under the tax benefit doctrine? No. 0111-0100

CONCLUSION

We believe that the tax benefit rule is not applicable. The sale of a percentage ownership interest in a nuclear power plant is not inconsistent with previous deductions taken for either interest or taxes. Obtaining ordinary deductions with regard to an asset that is subsequently sold and then obtaining capital gain under I.R.C. § 1231 is essentially inherent in that provision. The provision in the sales agreement for reimbursement of costs is a means of stating part of the sales price and not a *per se* recovery of the previously deducted amounts. This conclusion assumes that you have considered whether any of the deductions at issue should have been capitalized instead of deducted.

FACTS

Several electric utility examinations involve sales of portions of ownership interests in nuclear power plants which are under construction. Contracts of Sale generally provide that the sales price will be determined with reference to a percentage of actual costs incurred prior to closing, the percentage equalling the percentage ownership interest being purchased. Two specific provisions are as follows. The purchase price of the ownership interest in the portion of the plant acquired, constructed or completed prior to closing shall equal the sum of 5% of all costs of construction incurred prior to closing and carrying costs with respect to such 5% of construction costs defined as the aggregate incremental dollar cost of long term debt incurred prior to closing with respect to that portion of the plant acquired, constructed or completed prior to closing. Another sale required the purchasing company to pay a proportionate share of all capital costs and expenses incurred in connection with the project, including interest. The payment for a 6% undivided ownership interest was to equal 6% of construction costs including capitalized items (taxes, allowance for funds used during construction-AFUDC) incurred through closing. The total amount is referred to as book cost. Because of differences in treatment of taxes and AFUDC for book and tax purposes, the seller's tax basis in the portion of the plants sold is less than book basis. For federal income tax purposes, the interest component of AFUDC is deducted in the years incurred. For book purposes, taxes and AFUDC are capitalized resulting in a higher book basis than tax basis.1/ Subsequent to closing, the seller utilities reduce their book balances of AFUDC and capitalized taxes by the percentage of cost received upon the sale. The sellers treat the amounts realized as capital gains; the agents' adjustments treat the amounts as ordinary income (reimbursements of deducted costs).

Taxpayers argue that the agents have confused the sale of property and the determination of a fair price for that property. The purchase prices agreed to by the parties were amounts necessary to insure that sellers received a fair price and realized neither book gain nor loss. To accomplish this result, both book cost and tax basis on the portion of plants sold had to be determined. Taxpayers point out that it is not unusual for sellers of real property to start with costs incurred in determining a selling price and that such costs invariably include amounts deducted for tax purposes. Taxpayers state that the references to proportionate share of all capital costs and expenses is a way of measuring and stating purchase price and is not a reimbursement for costs incurred, that is a reimbursement to the seller for amounts incurred on the purchaser's behalf. Taxpayers strongly disagree with the conclusion that buyers purchased each of the individual elements

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1/ AFUDC will be discussed infra. Interest is one component of AFUDC. The other portion is a return on equity which is also capitalized for book purposes. For tax purposes, the return on equity is neither capitalized nor deducted.

making up book cost. Taxpayers state that previous interest deductions were proper, and the sale proceeds did not reduce the proper amount of the deductions. Therefore, the tax benefit rule does not apply.

DISCUSSION

I. Allowance For Funds Used During Construction (AFUDC)

Because the proposed adjustment at issue focuses on the tax benefit rule as applied to a reimbursement of interest expenses, a consideration of the utility accounting technique of AFUDC provides background for further analysis.

AFUDC is a major empirical and theoretical difference between the financial statements of regulated public utilities and other businesses. It is a technique used to capitalize and defer the cost of funds used to finance ongoing construction projects. Such projects are financed by borrowing money and by internally generated financial resources, including the sale of stock (equity financing). AFUDC represents an attempt to match the costs of a construction project, including financing costs, with benefits generated by the project. The practice is premised on the regulatory principle that current consumers should pay a return only on assets that are currently in service. An AFUDC rate is established by the utility and ratemaking authority and applied to the balance of construction work in progress (CWIP), excluded from the rate base. The resulting credit is divided between the amount pertaining to borrowed funds and the amount pertaining to equity funds, with the total added to CWIP. For financial accounting, AFUDC or interest income creates an identifiable plant cost, and is a device used purely for ratemaking and financial reporting purposes. Actual interest expense incurred is deducted for tax purposes.

When a project is complete and the plant placed in service, the utility will depreciate the facility. The cost to be depreciated over the life of the project consists of construction costs including the AFUDC added to CWIP. The capitalized AFUDC interest is added to the basis of the plant under construction and is included in the rate base as a component of the plant in service account and accordingly both earns a return for the utility and is recovered through depreciation over the life of the plant.

AFUDC relating to interest expense (debt financing) is a classic instance of a timing difference between book and taxable income. The interest expense is deductible for tax purposes, but is deferred and recognized as depreciation expense over the life of the asset for book purposes. the equity financing portion (opportunity cost of using invested capital) has no related tax effect. See Robert Bunch, "The Tax Effects of AFUDC" in Joel Berk, ed., Public Utility Finance and Accounting (1986).

II. Tax Benefit Rule.

The tax benefit rule was judicially developed in order to allay some of the inflexibilities of the annual accounting system. Hillsboro National Bank v. Commissioner, 460 U.S. 370, 377 (1983).2/ The rule requires the recognition of income when a subsequent event occurs that is "fundamentally inconsistent with the premise on which the deduction was initially based. That is, if that event had occurred within the same taxable year, it would have foreclosed the deduction." Id. at 383-84. The rule in effect creates an artificial income item in a later year to reverse a deduction erroneously taken in an earlier year. The purpose of the tax benefit rule is:

> to achieve rough transactional parity in tax, ... and to protect the Government and the taxpayer from the adverse effects of reporting a transaction on the basis of assumptions that an event in a subsequent year proves to have been erroneous. ...

Id. at 383.

Thus, the tax benefit rule deals with the situation in which the deduction becomes improper due to the occurrence of a fundamentally inconsistent event after the close of the tax year in which the deduction was claimed.

In the Bliss Dairy portion of Hillsboro, a corporation deducted the cost of cattle feed purchased for use in operations, and in the next taxable year adopted a liquidation plan and distributed assets, including much of the feed, to its shareholders. The distribution of the expensed assets was held to be inconsistent with the earlier deduction because the deduction was premised on consumption of the grain in business operations. The court viewed the distribution in liquidation as similar to a nonbusiness or personal use. Therefore, Bliss Dairy had to take into income the amount of the earlier deduction. Id. 395-96.

In summary, the principle laid down by the Supreme Court in Hillsboro, in the context of section 162 deductions, focuses on transactional parity and the matching of income and expense. The tax benefit rule is triggered by a fundamentally inconsistent event that distorts the matching of income and expense. The fundamentally inconsistent event of liquidation obviated the correlation of cattle feed expense to the generation of income which distorted income and compelled application of the tax benefit rule.

2/ The Supreme Court consolidated Hillsboro National Bank v. Commissioner, 641 F.2d 529 (7th Cir. 1981), and Bliss Dairy, Inc. v. United States, 645 F.2d 19 (9th Cir. 1981).

The Court was careful to point out, though, that not every unforeseen event will require a taxpayer to report income in the amount of the earlier deduction. Rather, the earlier deduction is cancelled out only if the later event is indeed fundamentally inconsistent with the premise on which the deduction was based, rather than merely unexpected. Id. at 383. In some cases only a subsequent recovery would be fundamentally inconsistent with a deduction. For example, the Court notes that a calendar year taxpayer's deduction of a rental payment made on December 15 would not be recognized as income under the tax benefit rule if the leased premises are destroyed by fire on January 10. The inability to occupy the building would not be an event fundamentally inconsistent with the prior deduction. Id. at 384-85. Similarly, we believe the sale of the ownership interests herein are not fundamentally inconsistent with the owners' previous interest deductions.

The Court also noted that if the lessor, subsequent to the fire, refunded the rental payment, the taxpayer would recognize income under the tax benefit rule. The subsequent recovery of the deducted rental payment would be inconsistent with the provision allowing the deduction. As will be discussed infra, we do not believe there is a factual or legal basis to take the position that taxpayers have recovered previously deducted interest (i.e. purchasers are paying such interest). Assuming arguendo, that purchasers are paying "interest," case law establishes that such payments are considered part of the amount realized upon the sale because such expenses are not expenses of purchasers prior to closing.

Lastly, the essence of the tax benefit rule is adherence to the annual accounting system and the problem of taxpayers mischaracterizing events. Either recognized income turns out not to be income or deductions turn out not to be deductions. The tax benefit rule does not apply to properly deducted expenditures and properly recognized income such that the two should be matched in the same year. "The tax benefit rule does not permit the Commissioner or the taxpayer to rematch properly recognized income with properly deducted expenses; it merely permits a balancing entry when an apparently proper expense turns out to be improper." Id. at 389 fn.24. In the instant issue, we believe that the essence of the proposed position is an incorrect effort to rematch properly deducted expenses with properly recognized income.

III. Amount Realized Not Reimbursement of Costs

In Weyher v. Commissioner, 66 T.C. 825 (1976) the issue was whether upon the sale of certain realty, taxpayer recovered interest which had been prepaid and deducted and, therefore, the recovery was income under the tax benefit rule. Weyher is distinguishable from the instant case and demonstrates why the tax benefit rule applies in Weyher and not in the instant case.

Upon purchase of the property, taxpayer prepaid and deducted interest (cash basis taxpayer) and at the time of his subsequent sale of the property two years later, the majority of the interest remained unaccrued (payments were scheduled for 14 years). The terms of the contract for taxpayer's sale of the property were "essentially identical in character and amount to that which he had recently paid in purchase of it." 66 T.C. at 827. Although taxpayer argued that the sales price was intended to reflect the fair market value and not to reimburse him for prepaid interest, the court found otherwise. Because the purchase price plus prepaid interest and selling price were equal and the parties to the latter contract were petitioner and a corporation in which he held a 77% interest, the court discounted the degree to which the parties were influenced by fair market value considerations, and held that it appeared the parties intended to reimburse petitioner for the costs incurred in acquiring the property. One such cost was the unaccrued prepaid interest which was, therefore, recovered.

In essence, the Court found that there was a close relationship between the two events such that the reimbursement emanated from the same transaction that generated the deduction. That is, the facts established that the intent of the parties was to reimburse taxpayer for the prepaid interest expense.3/ This result is to to be distinguished from the contracts at issue which involve arms length transactions and arguably an intent to set a fair market value rather than provide an actual reimbursement of expenses properly attributable to the seller utilities. Clearly the sales at issue herein do not emanate from the same transactions which generated the interest deductions for the seller utilities.

The tax benefit rule as applied in Commissioner v. Anders, 414 F.2d 1283, cert. den. 396 U.S. 958, reh'g den. 396 U.S. 1031 (1969) involved a similar concept; that is, the rule applied to the sale of previously expensed segregable assets from the capital asset sale of the entire business. In Anders the portion of the gain from sale of corporate assets which was attributable to certain business assets (items held for rent to customers) which had been fully expensed upon purchase was held to be taxable as ordinary income. The court concluded that tax benefit principles called for treatment of the proceeds not as gain from sale of property, but as ordinary income which was deducted on purchase and recouped upon the sale.

We believe in the instant case that the sale of the nuclear plant interests is a capital transaction not the sale of a segregable tangible or intangible asset nor the actual reimbursement of expense items.

3/ The court has subsequently characterized the transaction as a sale of an intangible asset created by a previous deduction. Davis v. Commissioner, 74 T.C. 881, 902 (1980) (discussing Weyher). The sale of the intangible asset (pre-paid interest) is to be distinguished from the capital gains treatment accorded the rest of the proceeds.

We believe that taxpayers have correctly cited Rev. Rul. 85-186, 1985-2 C.B. 84 in support of their position. The ruling states that tax benefit recapture as ordinary income of previously deducted section 174 expenditures is not required upon the subsequent sale of the resulting technology. The ruling notes that the Hillsboro standard requires an analysis of whether the prior year deduction would have been allowed if the subsequent year event had occurred in the prior year, considering the purpose and function of the provision allowing the prior year deduction. The legislative purpose of encouraging research or experimental activity was accomplished in the year of the deduction because that is the year the expenditures were paid or incurred, and the subsequent sale of the resulting technology had independent significance and was not fundamentally inconsistent with the prior section 174 deductions. We believe that the sales at issue herein had independent significance and were not inconsistent with the sellers' deductions of expenses attributable to their property interests.

Case law establishes that a purchaser of real property may not deduct interest and real property taxes which accrue prior to the date of purchase. Prior to the date of acquisition, these deductions belong to the seller. When the purchaser pays taxes and interest, the payments are deemed part of the purchase price. Accordingly, if an amount is part of the acquisition cost of property for the purchaser, it is part of the seller's consideration, and the character of any gain is governed by the nature of the property.4/ For example, Koehler v. Commissioner, T.C. Memo. 1978-381 involved taxpayer's attempt to deduct mortgage interest which accrued prior to the date he became the owner of the subject property. The court held that such interest was not deductible but was a part of the cost of the property. In the instant case, the "interest" allegedly paid by purchasers is even more in the nature of the purchase price rather than interest because it is paid directly to the sellers as consideration. See also Rodney, Inc. v. Commissioner, 145 F.2d 692 (2d Cir. 1946) (assumption of liabilities in exchange for assets was a capital transaction and interest paid for period prior to transaction was part consideration for the assets).

In Commissioner v. Breyer, 151 F.2d 267 (3d Cir. 1945) a corporation received in liquidation all the assets of other corporations and paid tax deficiencies and interest. The court held that the interest accruing before the transfer date was paid by the transferees as part of the cost basis of the assets and not as interest as such.

4/ See also Treas. Reg. § 1.1001-1(b)(2) which provides that if the purchaser pays an amount representing real property taxes which are treated as imposed upon the seller then that amount shall be taken into account in determining the amount realized from the sale under section 1001(b) and in computing the cost of the property under section 1012.

Hanna v. Commissioner, No. 317 (B.T.A. Memo. 1942) involved a contractual exchange of stock in which taxpayer also agreed to pay any additional federal income tax and interest for the company whose stock taxpayer transferred. The court held that the subsequent interest payment was part of the consideration for the acquired stock. See also Koontz v. Commissioner, 28 T.C. 586 (1957) (interest payments assumed and paid by taxpayer subsequent to his initial purchase of voting trust certificates are a part of the purchase price of the certificates).

Finally, in the analogous case of Pratt-Mallory Co. v. United States, 12 F. Supp. 1020 (Ct. Cl. 1936) taxpayer purchased a business and the purchase price set out in the contract included an amount of interest on the purchase price. The court held that the interest represented an additional amount paid for the assets and thus represented part of the purchase price.

In summary, case law does not support a reimbursement theory under the facts at issue.

We also note that the agent's theory of a reimbursement or recovery is based in part on the fact that taxpayer sellers reduced each cost account by the agreed percentage of costs received for the transaction and therefore, each cost item was separately transferred to purchasers in the applicable percentage. In fact, once the plant is completed, all of the cost accounts are combined into a plant in service account. When placed in use the plant goes in the rate base and costs are recovered from consumers over plant life through depreciation. The book cost reduction was necessary as consumers must only pay for the portion of the plant owned by the utility.

If you have any further questions, please contact Joyce C. Albro at 566-3521.

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